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The Trans Pacific Partnership in Japan, Malaysia and Vietnam: Explaining the impact of the Trans Pacific Partnership on Asia-Pacific countries with differing income levels and exchange rate systems

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Explaining the impact of the Trans Pacific Partnership on Asia-Pacific countries with differing income levels and exchange rate systems

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The Trans Pacific Partnership (TPP) is a multilateral free trade agreement linking twelve Pacific Rim economies, which seeks to reduce or eliminate protectionist measures such as tariffs between member countries. Currently, it includes the countries of Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States and Vietnam, which in total account for 40% of global GDP (Economist 2015). The TPP is ambitious both in terms of the range of countries it unites and in the scope of issues it seeks to address. Notably, it addresses protectionist measures in agriculture, intellectual property and automobile industries, all of which are contentious areas of trade for its constituents (USTR 2015). It is also unique for a free trade agreement in that it is accompanied by a joint declaration by all member parties to "refrain from competitive devaluation" of their respective currencies (US Treasury Department). This paper will focus on the impact of the TPP on Japan, Malaysia and Vietnam, which in total cover a range of different income levels, exchange rate structures and economic conditions. In 2012, the Peterson Institute released a study estimating that as a result of the TPP, Japan's economy would expand by 2.24%, Malaysia's economy by 6.10% and Vietnam's economy by 13.57%. This set of expected results is noteworthy both in that there is a very distinct hierarchy between expected output growth in these three countries, and also in that the expected output growth in both Malaysia and Vietnam far outstrips the expected output growth in any other country within the TPP. The objective of this paper is to investigate whether this hierarchy is accurate, and if so why the TPP is expected to impact these three Asia-Pacific economies so differently.

First, even though these countries have different expected growth rates as a result of the TPP, they are all very likely to benefit from this trade agreement to some extent. Under a general theory of comparative advantage, free trade agreements benefit each country within them by allowing each country to focus on its comparative advantage, leading to a rise in national outputs, allowing all countries to consume more and raise the economic well-being of their citizens. Free trade agreements are also beneficial for long term economic growth because they prompt countries to become more open to capturing new ideas and innovations, thereby increasing total factor productivity growth in each country (Nishimizu and Robinson 1983, Todo 2013). Specifically, the TPP

is likely to lead to some common advantages for all three of these countries. Since none of these countries currently have free trade agreements with the United States (Fergusson et. all 2013), which is the biggest economy amongst all TPP partners, by joining the TPP each of these countries is likely to see significant increases in their trade volume with the United States. Given that the United States is an important worldwide importer of goods and services, this increased trade will most likely increase net exports for all three Asia Pacific countries. Another significant source of growth for all countries will come an increase in exports from small- and mid-sized companies. These companies traditionally lack the economies of scale to afford exporting their products, but given lower protectionist barriers will be more able to compete against international firms (Gerwin 2015). All these ideas suggest that each of the three countries examined will see an increase in net exports under the TPP, leading to an increase in overall output within each economy. Since these countries already have significant current account surpluses (CIA Factbook 2015), this increase in net exports will further improve their current accounts.

One of the most obvious ways in which these three countries differ is in their relative income levels. The World Bank classifies Japan as an OECD high income country, Malaysia as a upper middle income country and Vietnam as a lower middle income country (2015). There are many reasons why Vietnam and Malaysia, as lower income countries, are more likely to benefit from the TPP. In the short to medium term, Vietnam and to some extent Malaysia will see significant boosts in their low education, labor-intensive manufacturing sectors, and in particular their textiles and processing industries (Fergusson et. all 2013). Given high demand for low cost footwear and clothing from markets in the United States and Canada, both countries will see a rise in net exports to Western markets once protectionist barriers to such markets are reduced or eliminated. Vietnam is especially likely to benefit from this comparative advantage given that it has a lower GDP per capita than Malaysia (World Bank 2015), and hence will be able to sustain a lower cost-base for its exports and outcompete its neighbor. In comparison, Japan's agricultural sector, which is regarded as largely inefficient (Economist 2013), will likely be outcompeted by foreign corporations once its protectionist barriers are lowered. Under the TPP, Japanese import competing firms are likely to suffer significantly

given that Japan, as a high income country, has a relatively high cost-base for its products and may not be able to compete against countries with lower cost-bases for their exports. This means that the rise in net exports within Japan is likely going to be lower than the rise in net exports within Malaysia and Vietnam.

In the long term, trade liberalization will allow Vietnam, perhaps following the example of Mexico and other countries whose economies have developed through increased trade, to “move up the value chain” into higher sector industries, for instance developing its flourishing electronics sector, and hence continuing to increase its net exports in the future (Gerwin 2015). This will allow economic growth in Vietnam to be sustained beyond simply its manufacturing sectors, prompting further growth and development in the country. This is less possible for Japan and Malaysia, which as higher income countries have less room for expansion into higher sector industries. In particular Japan already has very significant automobile and electronics sectors, and is less likely to be able to move into even higher sector industries. Also, even though free trade agreements tend to boost total factor productivity in all of their member countries, high income countries are more likely to see diminishing returns to an increase in their total factor productivity, leading to a comparably smaller output increase.

Lower income countries may also face higher growth for reasons unrelated to trade. Lower income countries tend to benefit from “catch up growth”, a theory that states that the lower income a country is, the more scope it has for achieving rapid growth by emulating the technologies and previous growth strategies of higher income countries (Advent 2013). Catch up growth is especially likely for Vietnam, which like many other newly industrialized Asian countries is adopting an export-oriented model of growth. Given that there are many models amongst the Asian tigers and other newly emerging Asian economies of successful export-oriented growth, Vietnam and to a lesser extent Malaysia should be able to benefit from the collective experimentation of those before it (Economist 2014, Heitger 1993). On a micro level, firms within low income countries can also become greatly more innovative from increased trade, especially with firms from high income countries which often have a greater ability to conduct more R&D. Since firms from low income countries tend to have

less research capabilities, they tend to be more inefficient and thus stand to gain the most from increased trade with more efficient firms. While there may be some increase in innovation within Japanese firms due to trade liberalization (Todo 2013), there is likely to be a comparably greater increase in innovation with Vietnamese and Malaysian firms, hence contributing to significant long term growth within both countries.

Another difference between these three countries is in their varying exchange rate structures. The Japanese Yen is a free-floating currency. Malaysia's ringgit has a managed float against the dollar, implying that the "central bank (will) intervene in the foreign exchange market to smoothen short-term fluctuations" of the currency, but that barring large fluctuations in the foreign exchange market the ringgit acts as though it were a "cleanly" free floating currency (Ariff 2005). The Vietnamese dong has a crawling peg against the US dollar, meaning that it maintains currency price stability and certainty while allowing the dong to remain relatively close to its market value (Ohno 1999).

In general, fixed exchange rate systems tend to amplify output growth that is caused by an increase in net exports, whereas flexible exchange rate systems tend to mitigate this growth. When net exports increase in a country, its rate of return on investment will rise above global rates of return. In a flexible exchange rate system, when this occurs the country's currency will appreciate, leading to an increase in global rates of return and a decrease in net exports until the domestic rate of return and global rates of return come back to equilibrium. The net effect of these changes is that output growth is slightly mitigated by the appreciation of a currency. However, in countries with fixed exchange rate regimes, the country’s currency cannot appreciate to correct for the misalignment between global and domestic rates of return. Instead, capital flows from abroad will increase, therefore increasing the money supply in a country until domestic interest rates equal global interest rates. The net effect of these changes are that in fixed exchange rate regimes, an increase in the money supply of an economy will lead to an additional boost in output. This difference in how exchange rate regimes influence output growth partially explains why Vietnam, as a country with a

fixed exchange rate regime, is expected to see higher growth from the TPP than its two neighboring economies.

In addition to having different exchange rate systems, the three countries in question also have different economy sizes. Japan is by far the largest economy out of the three, with the third largest GDP in the world and a large trade volume with many other countries (World Bank 2015). As a large economy, when its interest rates rise, global interest rates will also rise to a lesser degree. This rise will decrease the discrepancy between Japanese and global rates of return on investment, meaning that the Yen will appreciate less and that output will correspondingly be less affected. This suggests that Japan, as a larger flexible economy, is likely to see a lesser mitigation on its economic growth than Malaysia, a smaller flexible economy.

However, this comparative effect is not entirely certain. Given that we have established the TPP is likely to boost output (and therefore raise interest rates) in all of its partner countries due to the theory of comparative advantage, and since the countries involved in the TPP include very large economies such as the United States and Japan, it is likely that the TPP will cause an overall increase in global interest rates. This means that the difference between domestic rates of return and global rates of return in all three of our economies will be smaller than previously thought. In a small flexible exchange rate regime like Malaysia, this means that the mitigatory effect of currency appreciation on output growth will be smaller than indicated earlier. In a small fixed exchange rate regime like Vietnam, this means that the amplification effects of increased capital flows from abroad on output growth will also be smaller than indicated. The overall effect of these caveats is that while the different currency regimes adopted by these three countries will affect their output growth under the TPP to some extent, because of the anticipated change in global interest rates due to this partnership, the respective mitigating and amplifying effects of flexible and fixed exchange rates will account for only a small part of the discrepancy in output growth between the three countries.

There are also unique economic and political distinctions within each country that could impact how they respectively react to the TPP. Within Japan, depending on the Bank of Japan (BOJ)'s reaction to the TPP, the Japanese Yen could either strengthen or remain stable, which would

therefore influence Japan's output. On the one hand, economically, the BOJ has a strong incentive to introduce more monetary easing in order to keep the Yen from appreciating (Elam 2015). This would be consistent with "Abenomics", which has emphasized preserving low currency values through frequent quantitative easing packages. On the other hand, politically this could be a dangerous move for Japan. This year, Japan has pledged twice to refrain from "competitive devaluation" of its currency, first as a TPP member and secondly as an APEC member (US Treasury Department, Reuters). It is uncertain what the political repercussions of reneging on its agreement to refrain from competitive currency devaluation would be for Japan, given that this declaration does not come with any tangible punishment mechanism, but nevertheless there will likely be hidden political repercussions to competitive devaluation. On an economic level, if there is a strong likelihood that other TPP members will genuinely avoid currency devaluations, then basic game theory dictates that Japan should also avoid devaluing its currency in order to avoid starting a "currency war", in which all countries start devaluing their currencies in a "race to the bottom", leading to higher inflation rates all around and no overall advantage for any one country. While Malaysia and Vietnam may not be so prominently known for their quantitative easing practices, as APEC members they both share similar economic advantages and econopolitical disadvantages to the competitive devaluation of their respective currencies. The advantage of devaluation may be especially great for Malaysia, since as a small flexible exchange rate regime,its currency is the most likely to appreciate. The decision of each country to competitively devalue its currency and the corresponding econopolitical implications of such a decision will likely impact growth significantly, although not in any predetermined direction.

Finally, each economy also faces unique economic conditions which will impact consumer and investor reactions to the TPP. Japan's economy has largely stagnated since the 1990s (Economist 2009), which has corresponded with low consumer and investor confidence within the economy. Even if the TPP does lead to higher output in Japan, if consumer and investor confidence remain low in the country then this output growth will be low and may not be sustainable in the long term. Given that the TPP has proved politically controversial for agriculture and car manufacturing industries in Japan (Economist 2015), the TPP may even lead to lower confidence in the economy, which would

negatively impact growth. Malaysia has seen very high growth in the last few years, with a GDP growth rate of 6.0% in 2014 (World Bank 2015). While there seems to be some political resistance to the TPP in Malaysia, for instance from citizens arguing that the TPP will cause medicine prices to rise (Malaysian Insider 2015), this resistance is likely to be mitigated by the fact that there are also very clear economic winners in Malaysia under the TPP. Therefore, confidence in Malaysia is likely to either rise considerably or at worst remain largely unchanged after implementation of the TPP. Vietnam has also seen incredible growth recently, with a GDP growth rate of 6.0% in 2014 (World Bank 2015). Furthermore, a review of literature on the TPP's impact on Asia Pacific countries consistently suggests that Vietnam is expected to be the "biggest winner" from the TPP (Economist 2015). This suggests that investor and perhaps consumer confidence in Vietnam are likely to be high following the implementation of the TPP, hence amplifying existing output growth even more. To the extent that investor and consumer confidence within each country behave in a predictable manner, growth should be amplified significantly in Vietnam, to some degree in Malaysia and to a minimal or even negative degree in Japan. Of course, this variable is necessarily less predictable than other variables, and so any changes in political attitudes towards the TPP or towards economic growth within any of these countries may affect the reliability of this analysis.

Through examining the countries of Japan, Malaysia and Vietnam, we can draw several conclusions about the impact of the TPP on countries with different economic compositions. In general, we can conclude that the TPP will benefit lower income countries more than higher income countries, and countries with fixed exchange rate regimes more than countries with flexible exchange regimes. In reviewing these sets of explanations closely, we can also conclude that some of these explanations are more convincing than others. On the one hand, Vietnam and Malaysia are especially likely to benefit from the advantages of increased access to developed markets and from "catch up growth", since they can emulate the established export-oriented development models of the many newly industrialized Asian economies that have come before them. On the other hand, while it is true that fixed exchange rate regimes tend to do better than flexible exchange rate regimes given a boost to net exports, because the TPP involves such large economies and is likely to have a significant

effect on global interest rate structures, both the disadvantages of having a flexible exchange rate structure and the advantages of having a fixed exchange rate structure will be minimal, and hence this distinction does not fully explain the large discrepancies in expected output growth between the countries examined. Furthermore, economic and political distinctions between these three countries will necessarily play a role in how the TPP is received in each country. If a country is willing to devalue its currency, this could give its exports a competitive edge, but could also lead to political penalties or economic retaliation in the form of a currency war. If confidence rises in some countries more than in others, this will amplify growth for countries facing high confidence. Ultimately, while the clear hierarchy of economic growth as incurred under the TPP within Petri et. all's analysis (2012) still stands as largely valid, the specific nuances of how each country will fare under the TPP will be determined by the combination of economic and political factors outlined in this paper.

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